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SIPDIS

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SUBJECT: TURKISH MARKET SWINGS OVER CYPRUS REFERENDUM,
GREENSPAN COMMENTS

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SENSITIVE BUT UNCLASSIFIED--HANDLE ACCORDINGLY.

[1](#)1. (SBU) Summary: Turkish financial markets were flat today in the final day of trading before Saturday's referendum in Cyprus. The relative calm came after a week in which the IMKB-100 bounced up and down as sentiment shifted on prospects for a favorable outcome to the vote. A strong rally late last week and early this week was followed by profit-taking and nervousness on April 20 and 21 as many foreign investors closed their positions. One leading analyst here estimates that as much as 800 million USD may have left the country this week though a Central Bank official put it at 500 million. As a result, the lira continued to weaken through the week, breaking through the 1.39 million per USD level in early trading today, before easing to 1.382 at the close. Many analysts attribute the lira weakness against the dollar this week as much to anticipation of an upcoming Federal Reserve rate hike in the U.S. as to Cyprus worries. Meanwhile, this week's economic indicators have painted a mixed picture of the Turkish economy, with strong capacity utilization figures and tourism results sparking optimism, but an expanding current account deficit raising concerns about the worsening trade balance. The Central Bank is waiting until after this weekend's referendum to decide whether to reduce foreign exchange purchase auctions and, apparently, whether to reduce interest rates. End Summary.

[1](#)2. (SBU) Markets Yo-Yo: The markets rallied by a strong 3.11 percent on Friday, April 16, and another 3.46 percent on April 19 to flirt with the 20,000 level as sentiment waxed positive on Cyprus. As investors perceived an increase in tensions over the referendum the IMKB 100 stock exchange gave back half of those gains in mid-week to close yesterday at 19,279, just above its April 16 level. The market firmed slightly today, increasing to 19,431.5, in moderate trading as investors finalized their positions in advance of tomorrow's national holiday and the Saturday referendum. Interest rates also moved upward slightly during the week. The Turkish Treasury sold 2.187 quadrillion (1.6 billion USD) in three month bills at an auction on Tuesday, meeting its sale target but at a higher than expected yield. By the close today, the benchmark bond was trading at 22.81, compared with 22.36 at Monday's close and below 22 earlier in the month. With Cyprus concern compounded by the parity movements that saw the dollar strengthen on rumors of a Federal Reserve rate hike, the Turkish lira weakened throughout the week, reaching 1.395 million in morning trading on April 22, before easing to 1.382 million at the close. Much of the weakening against the dollar arose from the dollar's rally against Euro: the TL's decline against the Euro was much more muted. Against the Euro, the TL fell only from 1.625 at the end of last week close to 1.642 at today's close.

[1](#)3. (SBU) Market analysts tell econoffs that recent volatility was predictable in the run-up to the Cyprus referendum, though Fed Chairman Greenspan's comments--causing increased expectations of higher U.S. interest rates later this year--added to the impact on Turkey. Over the past week equity investors tested the 20,000 level, which the market approached on Monday, and then moved to take profits. Baturalp Candemir of HC Istanbul, a leading brokerage, echoed other Istanbul analysts in noting that the market has essentially priced in a yes/no outcome in Saturday's vote and implicitly removal of Cyprus as an obstacle to securing a negotiation date from the EU this December. Tefvik Aksoy of Deutsche Bank said only if the outcome does not reflect the North=yes/South=no outcome will the markets be volatile on Monday, though a

higher-than-expected yes vote in the South, even if below 50 percent, might cause a modest rally. According to Candemir, the Friday-Monday (April 16-19) rally led many foreigners to decide to close their positions and take their profits on Tuesday and Wednesday.

14. (SBU) Emrah Eksi, of the Central Bank Markets Department echoed Aksoy in putting greater importance on the Greenspan comments and the newly-increased expectation of higher U.S. interest rates than on Cyprus in explaining the sell-off in Turkish markets Tuesday and Wednesday. Aksoy noted that the Greenspan comments hit the broader class of Emerging Market Debt, not just Turkish bonds.

15. (SBU) Candemir estimated that the outflow this week totalled 800 million USD, and cited it rather than Turkey's worsening current account deficit as the major reason for the Turkish lira's depreciation this week to 1.382 million/dollar. The Central Bank's Eksi, on the other hand, told econoff only about \$500 million left the market this week, and placed less emphasis than Candemir on the impact of foreigners leaving the market. Aksoy said the foreigners pulling out were mostly at the short end of the yield curve or in equities, rather than longer-dated fixed income instruments.

16. (SBU) Candemir argued that the current account issue has been evident since last fall, but that the Turkish lira remained strong in the face of continued inflows of portfolio investment from abroad. Only once the foreigners began to sell, he argued, did the rate begin to weaken. The effect was compounded by the movement of Turkish banks to reduce the open positions they had established in recent months. Candemir suggested that an added reason for the foreign exodus from the market is the fact that there is "no good news on the horizon for the next several months." With both Cyprus and diminishing inflation priced in by the market, no further decline in interest rates or lira appreciation is on the horizon. He thus foresees a sluggish period in the market, which may last until the NATO summit again focuses world attention on Turkey.

17. (SBU) Good News/Bad News: While February's burgeoning trade deficit (up to nearly 2.4 billion USD) and the 12-month cumulative deficit of 24 billion USD raised concerns about the sustainability of Turkey's current account deficit, there was good news on the tourism front. January to March arrivals were up by nearly 43 percent from last year, reaching 1.924 million. While the base year effect played a large role, given that tourism slowed in the run up to last year's Iraq war, the increase showed the sector is clearly on the road to recovery and that this year's target of 11.5 billion in tourism revenue is within reach.

18. (SBU) Central Bank Wait-and-See: Despite the fall of the lira this week, the Central Bank continued its foreign exchange purchase auctions. Eksi told Econoff the Bank purchased \$40 million at auction yesterday and another \$40 million at auction today, plus an additional \$30 million outside the auction. According to Eksi, the Bank wants to avoid constantly altering its FX buying policy, and prefers to await the results of the referendum before deciding whether to ease off on the purchases. With the summer tourism FX inflow season beginning, the Bank wants to avoid cutting back on purchases only to resume a high level of purchases shortly thereafter as tourism FX inflows pick up. Aksoy noted that the markets were unhappy with frequent changes in the Central Bank's FX purchase levels.

19. (SBU) Aksoy also revised his predictions of a coming interest rate cut this week, expecting the cut to come later in the year and for a lesser amount. Whereas many analysts had been expecting a rate cut after the IMF Seventh Review board vote, the Bank appears to have preferred to wait out the pre-referendum volatility before making a decision. Aksoy told econoff that the weakened lira and signs of strong growth are likely to contribute to Central Bank caution about a rate cut.